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The Interaction of Scholarships and Tax Credits

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Tax Credits for Education

American Opportunity Tax Credit (AOTC)

- Equals 100% of first \$2,000 of spending + 25% of next \$2,000 for maximum credit of \$2,500
- 40% of the credit is refundable (e.g., taxpayer with no tax liability can receive up to \$1,000)
- Students must be enrolled at least half time, and in first four years of postsecondary education
- Must be pursuing a degree or credential
- Qualifying tuition and related expenses (QTRE) includes tuition, fees and course materials (e.g., books) required for enrollment or attendance



Tax Credits for Education

Lifetime Learning Tax Credit (LLC)

- Equals 20% of first \$10,000 of spending for maximum of \$2,000
- Non-refundable
- May be claimed for any number of years
- Students may be part-time and need not be pursuing a degree or credential
- Qualifying tuition and related expenses (QTRE) includes tuition and fees required for enrollment or attendance



Many Receive Scholarships

Many college students are eligible for both scholarships and for federal tax credits.

For example, over 9 million students per year receive federal Pell grants.

For the 2013-2014 school year, the maximum Pell grant was \$5,645.

About three-quarters of Pell grant students have family income less than \$30,000.

Tax Rules for Scholarships

Pell grants and many other scholarships can be treated in one of two ways for tax purposes:

- Excluded from student's income if used for tuition and related expenses. In this case, the scholarship must be subtracted from expenses that would qualify for the AOTC or LLC. Or,
- Included in student's income if used for living expenses. In this case, the scholarship does not reduce the amount of tuition and related expenses that can be used to claim the AOTC or LLC.



Students May Choose

Families may be able to increase their total refund or reduce tax liability by paying some tax on their scholarships and increasing their tax credit.

Students may choose whether to treat their scholarships as used for tuition and related fees (tax-free, but reduces expenses for credits) or as used for living expenses (taxable, but does not reduce expenses for credits).

See IRC regulation 1.25A-5 and examples in Publication 970 (page 14 of 2013 publication, <http://www.irs.gov/pub/irs-pdf/p970.pdf>).

Students May Choose

Student may allocate scholarships to living expenses (up to the amount of actual living expenses) regardless of how their school treats their Pell grant or other scholarship.

Only other restriction is that terms of the scholarship allow it to be used for tuition and related expenses or living expenses.

Students exercise their choice by deciding how much of their Pell grant to exclude from their income, and what expenses to claim for the AOTC or LLC.



Choice Is Clear for Some

Students with tuition and related fees well in excess of their Pell grant and other scholarships don't need to include any of their grants in income in order to claim the maximum AOTC.

Specifically, if $QTRE - \$4,000 > \text{scholarships}$, student can exclude scholarships from income and still maximize AOTC.



Choice May Be Complicated

If QTRE - \$4,000 < scholarships, the choice is more complicated.

Most Pell grant recipients will fall into this group.

For them, the tax minimizing choice depends on the student's marginal tax rate (including, e.g., EITC phase-out rate) and other factors.

If the student is a dependent, the tax minimizing choice for the family also depends on the parent's tax liability before accounting for the AOTC.



Choice May Be Complicated

In nearly all cases where $QTRE - \$4,000 <$ scholarships, the student should include enough scholarships in income in order to claim \$2,000 in expenses for the AOTC.

In many cases where $QTRE - \$4,000 <$ scholarships, the student should include enough scholarships in income in order to claim \$4,000 in expenses for the AOTC.

Example 1

This family minimizes tax by including \$4,000 in income and claiming \$4,000 of QTRE.

	Scholarship Used to Pay Living Expenses	Scholarship Used to Pay Tuition, Fees, and Books
Total Pell Grants	5,645	5,645
Pell Used to Pay Tuition, Required Fees and Books	0	4,000
Pell Used to Pay Living Expenses	5,645	1,645
Expenses Eligible for AOTC (up to \$4,000)	4,000	0
Total Income Parent	20,000	20,000
Taxable Income	3,000	3,000
Tax Before Credits	300	300
AOTC	1,300	0
EITC	2,958	2,958
Tax Liability of Parent ¹	-3,958	-2,658
Total Income Student (has \$2,000 earnings)	7,645	3,645
Taxable Income	1,445	0
Tax Liability of Student	145	0
Total Tax Liability of Family	-3,813	-2,658
Net Loss from Failing to Optimize Benefits ²		1,155

¹ Negative values indicate that the family is receiving a refund.

² The net loss from failing to optimize benefits equals the value of the foregone AOTC minus the tax the student avoids by using the Pell for tuition and excluding it from income.

Example 2

This student minimizes total tax liability by including \$2,000 of her grant in income.

	Scholarship Partially Used to Pay Living Expenses	Scholarship Used to Pay Tuition, Fees, and Books
Total Pell Grants	5,645	5,645
Pell Used to Pay Tuition, Required Fees and Books	2,000	4,000
Pell Used to Pay Living Expenses	3,645	1,645
Expenses Eligible for AOTC (up to \$4,000)	2,000	0
Total Income Student/Taxpayer	23,645	21,645
Taxable Income	6,645	4,645
Tax Before Credits	665	465
AOTC	1,465	0
EITC	2,376	2,695
Tax Liability of Student/Taxpayer ¹	-3,176	-2,231
Net Loss from Failing to Optimize Benefits ²		946

¹ Negative values indicate that the family is receiving a refund. Tax liability includes the EITC, which varies with income. We have assumed the dependent does not qualify for the child credit because the child credit is not affected in this example.

² The net loss from failing to optimize benefits equals the value of the foregone AOTC minus the tax the student avoids by using the Pell for tuition and excluding it from income minus the value of the increase in the EITC from excluding the Pell from income.



Thank You

Software can help millions of low- and moderate-income families claim the maximum education tax benefits to which they are entitled.

For more information:

<http://www.treasury.gov/connect/blog/Documents/Pell%20AOTC%204%20pager.pdf>

<http://www.treasury.gov/connect/blog/Pages/Helping-students-and-families-access-college-tax-benefits.aspx>

<http://www.irs.gov/pub/irs-pdf/p970.pdf>